PSG Wealth

The power of compound interest over time

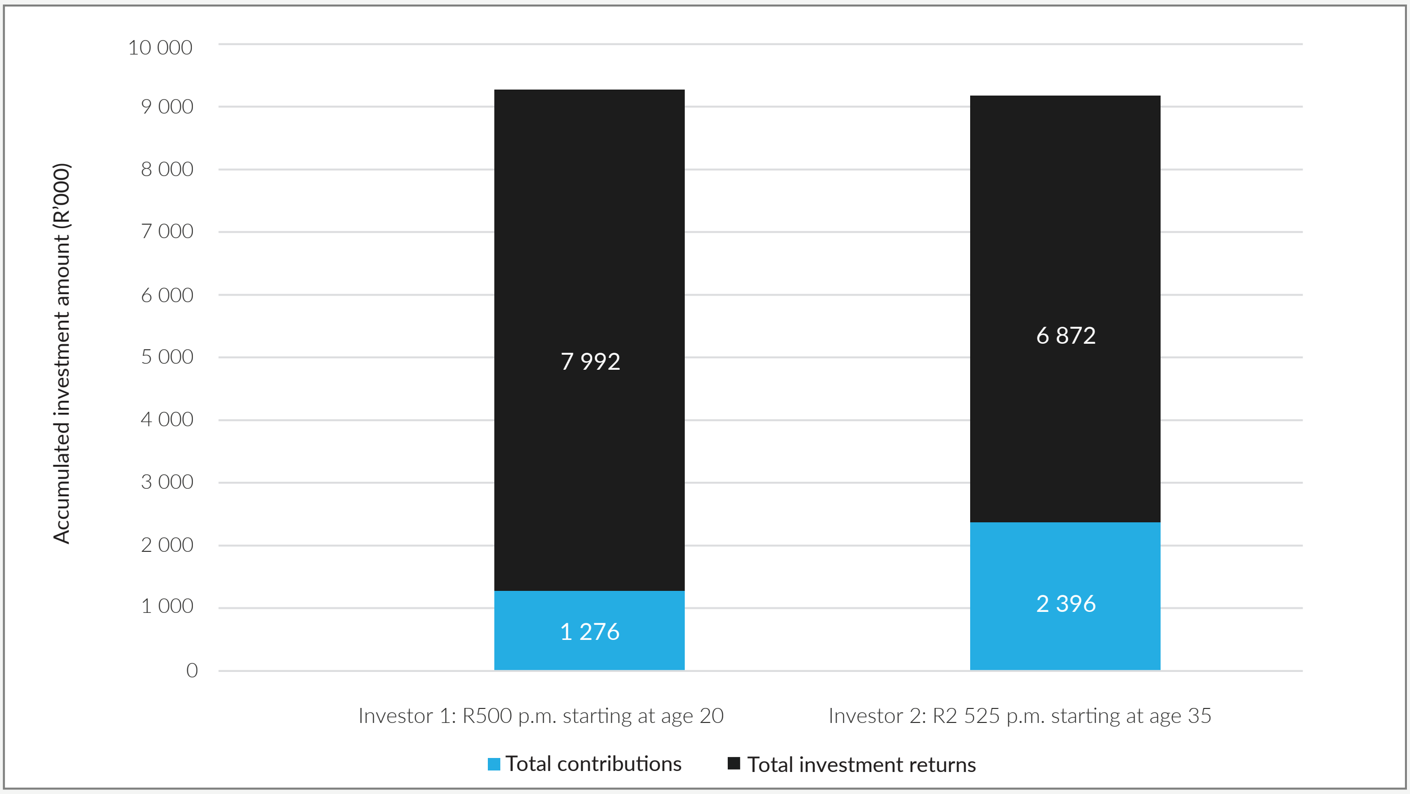
Start early and commit to saving

Whatever underlying fund or investment vehicle you choose, it's important to commit to saving and to start early. Compound interest is a powerful force that can help you achieve your targets – but its effects become more pronounced over time. This is best demonstrated using a simple example.

Visualising the power of compound interest

Let's compare two investors who both start saving in a retirement annuity (RA). Investor 1 starts saving for retirement at the age of 20 with a monthly contribution of R500 (investment term to retirement at age 65 is 45 years). Investor 2, who only starts saving at the age of 35 (investment term 30 years), has to contribute R2 500 per month in order to end up with the same amount at retirement. This is five times more per month than investor 1!

Compound interest compared to contributions to a retirement annuity



Assumptions: 10% p.a. net investment return; 6% p.a. contribution escalation. Retirement age: 65. No tax payable within the retirement annuity structure.

Investor 1 contributes about half of the total contributions of investor 2, who starts at age 35. Despite this, Investor 1 ends up with the same value at retirement, because compound interest takes care of the rest.

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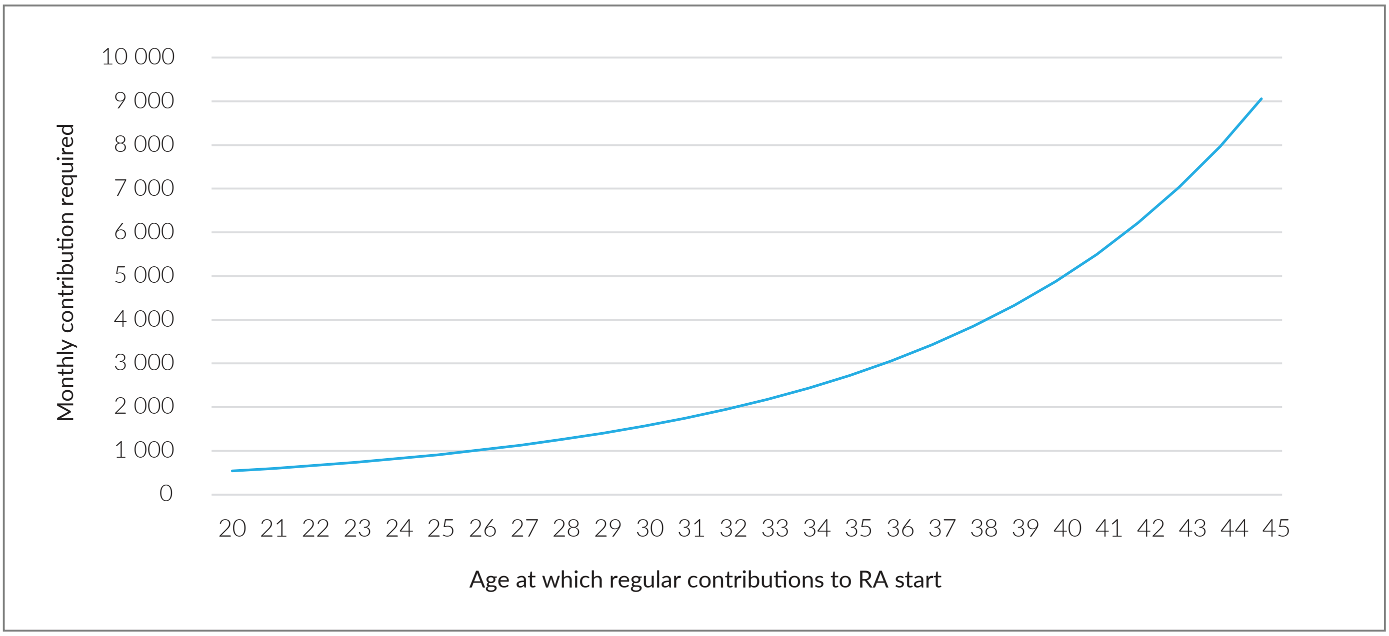
How much more do you need to save to reach a given target?

Another way of visualising the benefit of compound interest, is to consider how much more your monthly savings would require to reach a specified target. The graph below shows what the monthly contributions would need to be starting at different ages, in order to save an amount of R10 million at retirement.

Contributions required at different starting ages to reach R10 million target



Assumptions: 10% p.a. net investment return; 6% p.a. contribution escalation. Retirement age: 65. No tax payable within the retirement annuity structure. Amount accumulated at end of term is R10 million (nominal value, not inflation adjusted).

Increased benefit of compounding in a tax-efficient vehicle

Keep in mind that the benefits of saving in a tax-efficient vehicle like an RA and a Tax Free Investment Plan (TFIP) also add to the benefit of compounding.

Reinvesting is important

Whatever your underlying investment choice, it's important to reinvest your investment distributions. That's one of the key drivers of the benefit of compounding.

The most important thing when it comes to investing, is making a start. Your financial adviser can help you to understand the options available to you, and weigh up their relative benefits better.